Supreme Court, U.S.
FILED
JAN 21 1992
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91-1191

No.

IN THE UNITED STATES SUPREME COURT

OCTOBER TERM, 1991

RICHARD P. HECKER, Petitioner

v.

FRANKLIN NATIONAL BANK, Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT, NO. 89-7255

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Was petitioner ineligible for a bankruptcy discharge under the Bankruptcy Act fraud exception of 11 U.S.C. § 523 (a)(2)(A) by acting with "reckless disregard of the truth" in pledging his corporate stock for a $50,000 bank loan without actual knowledge that the stock was restricted?

II. Did petitioner make a "false representation" for "fraud" purposes where his corporate stock was restricted, but a prior financial statement showed the shares as "restricted", and the stock did have some (undetermined) value as collateral?

III. Did petitioner "intend to deceive" the bank when he acted on recommendation and advice of corporate counsel?

IV. Did petitioner have both requisite "knowledge" and "intent to deceive" when he acted on advice of corporate counsel, and the documents he originally signed imposing restrictions on the transfer of the stock indicated the restrictions did not apply upon receiving a favorable opinion of corporate counsel?

V. If petitioner did misrepresent the stock restrictions to the bank, did the bank actually rely on these misrepresentations, and, if so, was

this reliance "reasonable"?

VI. Did petitioner's conduct constitute "proximate cause" of the loss when the creditor bank, having the burden of proof as the plaintiff in the Bankruptcy Court, failed to prove at trial the stock had insufficient collateral value at the time of the stock pledge and loan?

VII. Does a bona fide, good faith recipient of restricted publicly-traded stock as collateral have the right to liquidate the security on default free of the restrictions?

PARTIES

Petitioner: Richard P. Hecker

Respondent: Franklin National Bank

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Statutes/Regulations:	Pages
11 USC § 523(a)(2)(A)	16, 31, 47, 55
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REFERENCE TO OTHER REPORTS

(All Unpublished)

1. Oral Decision of Bankruptcy Judge November 21, 1988 (App. pp. 25-69).

2. Bankruptcy Judge's Decision Granting Motion to Amend Judgment, and Judgment, dated January 6, 1987 (App. pp. 70-90 and pp. 91-93).

3. Opinion of U.S. District Court sitting as Appellate Court-Judge Harold H. Greene, September 22, 1989 (App. pp. 94-113).

4. U.S. Court of Appeals Decision, October 23, 1991 (App. pp. 2-5).

STATEMENT OF GROUNDS FOR JURISDICTION

1. Date of Entry of Judgment Sought to be Reviewed: October 23, 1991.

2. Relevant Statutory Provision:

28 U.S.C. § 1254 (1)

CONSTITUTIONAL PROVISIONS, TREATIES STATUTES, ORDINANCES AND REGULATIONS INVOLVED

11 U.S.C.§ 523(a)(2)(A):

(a) A discharge under Section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-

.....

(2) for money, property, services, or extension, renewal, or refinancing of credit, to the extent obtained, by-

(A) false pretenses, a false representation or actual fraud, other than a statement respecting the debtor's or an insider's

financial condition....

15 U.S.C. Section 771

Any person who-

(1) offers or sells a security in violation of section 77e of this title...

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Regulation §230.144-SEC

17 C.F.R. §230.144

...

(b) Conditions to be Met. Any affiliate or person who sells restricted securities of an issuer for his own account, or any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities, shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof within the meaning of Section 2(11) of the Act

if all of the conditions of this rule are met.

STATEMENT OF THE CASE

1. Jurisdiction of Court of First Instance (Bankruptcy Court)

11 U.S.C. § 11

2. Statement of Facts

Petitioner, Richard P. Hecker (hereinafter "petitioner" or "Mr. Hecker") with his wife, Ellen F. Hecker, filed Chapter 7 bankruptcy on May 8, 1988 in the United States Bankruptcy Court for the District

of Columbia in case number 88-0274. Respondent, Franklin National Bank of Washington, D.C., Successor-In-Interest to National Enterprise Bank of Washington, D.C. (hereinafter collectively referred to as "respondent" or "bank"), filed a complaint to determine non-dischargeability of two outstanding loans to Mr. Hecker (AP No.88-0021). In October, 1986, the bank had loaned $50,000 to Mr. Hecker for the purpose of re-loan to Applied Optics, Inc., Mr. Hecker's employer. In 1987, that institution loaned another $13,200 to Mr. Hecker.

The Bankruptcy Judge ruled that the $13,200 loan was indeed dischargeable, but the $50,000 loan

was not dischargeable on the grounds of "fraud" as provided in 11 U.S.C. 523(a)(2)(A).

Mr. Hecker appealed the decision of the Bankruptcy Court to the United States District Court for the District of Columbia in case number 89-0323. The District Court Judge affirmed the decision of the Bankruptcy Judge on the grounds that none of the findings of the Bankruptcy Judge were clearly erroneous. Mr. Hecker appealed to the United States Court of Appeals for the District of Columbia Circuit in case number 89-7255. The Court of Appeals affirmed the decision of the District Court, also on the same grounds.

The recipient of the $50,000 proceeds, Applied Optics, Inc., manufactured contact lenses in Maryland (App. pp. 16-18). On March 1, 1985 petitioner joined Applied Optics as an executive vice president, secretary and treasurer (App. pp. 16-18). He also supervised payroll, purchasing and personnel (App. pp. 16-18). Petitioner had no training or experience in securities when he joined the corporation (App. pp. 19-21). He had never participated in any other public corporation (App. pp. 19-21).

Approximately September 26 or 28, 1985, Applied Optics, Inc. went public (App. pp. 18-19). In

conjunction, on July 24, 1985, petitioner signed about 150 to 200 documents (App. pp. 19-21) prepared by the corporation's attorney, Thomas Prousalis (App. pp. 19-21). An SEC S-18 public registration form and stockholders agreement (See pp. 105-106 at App. pp. 114-115) were filed on August 22, 1985, signed by five shareholders. Petitioner signed in his capacity as secretary of the corporation (App. pp. 15-17).

Both a public stock offering prospectus and the shareholders agreement restricted the transfer and/or sale of the petitioner's stock for three years from August 22, 1985. The provisions were worded in effect, "Shareholders

shall not sell, pledge, hypothecate, donate or otherwise transfer their shares of common stock" (App. pp. 15-16). However, the terms of the restriction also provided for relief from these restrictions "...UPON THE ISSUANCE TO THE COMPANY OF A FAVORABLE OPINION OF ITS LEGAL COUNSEL AND/OR THE SUBMISSION TO THE COMPANY OF SUCH EVIDENCE AS MAY BE SATISFACTORY TO LEGAL COUNSEL TO THE COMPANY, IN EITHER CASE TO THE EFFECT THAT ANY SUCH TRANSFER SHALL NOT BE IN VIOLATION OF THE SECURITIES ACT OF 1933, AS AMENDED AND APPLICABLE STATE SECURITIES LAWS" (App. pp. 114-115). The petitioner received a favorable opinion from Applied Optics

corporate counsel before he pledged his stock as collateral on the $50,000 loan in question (App. pp. 22-25).

Well before making the subject loan of $50,000 in October, 1986, petitioner informed the bank of Applied Optics' new public stock offering. The bank was regularly kept apprised of the corporation's financial status (App. pp. 21-22).

Since the public offering was directly handled by Mr. Prousalis, the company's counsel, petitioner had a peripheral role. As a result of his limited role and non-securities background, petitioner mistakenly thought these restrictions lasted only 24 to 30

months from the time of the original incorporation approximately December, 1983) (App. p. 45).

On or about March 3, 1986, about six months prior to the negotiations for the $50,000 loan, petitioner had filed a financial statement with the bank referencing his Applied Optics stock, which were listed as "restricted" (App. pp. 21). The bank's loan officer customarily reviewed old financial statements before making loans (App. pp. 7-9) and used that financial statement to make the $50,000 loan.

Mr. Hecker subsequently submitted another financial statement dated October 27, 1986, after receiving the October 3, 1986

loan of $50,000 at issue, listing the same shares of stock , but not showing them as restricted because of corporate counsel's favorable opinion that the stock could then be pledged as collateral (App. pp. 22-25)

Applied Optics' attorney, Thomas Prousalis, who handled all the company's security work and stock certificate records, and kept petitioner's publicly traded shares, had advised and suggested to petitioner to use all his Applied Optics shares to obtain the $50,000 bank loan for the benefit of Applied Optics (App. pp. 23-25). On approximately September 23, 1986, petitioner acted on attorney

Prousalis' recommendations, and he contacted the bank about using his stock as collateral for the $50,000 loan (App. pp. 33).

On October 3, 1986, when Mr. Hecker actually borrowed the $50,000 from the bank, he believed the corporation was financially unable to borrow it on its own. He was, however, advised by attorney Prousalis that he could take out a "personal loan" (App. pp. 23-25) and turn the proceeds over to the corporation. Petitioner had told counsel that he had no property upon which to borrow (App. pp. 25). Petitioner was unaware of the continuing validity of any stock restrictions (App. pp. 22-23).

The bank did not have any established procedures for determining whether the stock was validly issued to a person presenting stock certificates as collateral. The bank never made the simplest inquiries into the validity of the shares (App. pp. 7-11), and never inquired of petitioner whether the stock was restricted (App. pp. 7-11).

Apparently, the loan officer never checked with the SEC, despite knowing that the corporation had relatively recently gone public, and Mr. Hecker's status in the corporation, and that therefore insider shares were almost certainly subject to SEC restrictions (App.

pp. 7-11). Further, the loan officer never asked the corporate attorney, nor anyone about possible stock restrictions (App. pp. 7-11).

Thus the loan officer did nothing to verify the validity of the stock certificates (i.e., whether the shares were validly issued so they could be traded or if restrictions applied) (App. pp. 7-11). The loan officer did, however, check the value of the stock in the Wall Street Journal and with a brokerage firm, Charles Schwab (App. pp. 7-11).

With the $50,000 loan taken on October 3, 1986 upon advice of counsel (App. pp. 23-25), petitioner bought Applied Optics stock, and

lent the rest of the money to the company. (App. pp. 12-13) The company was having financial troubles at this time (App. p. 13). The loan proceeds were used by the corporation for normal operating expenses, including payroll (App. p. 48).

Mr. Hecker made timely payments throughout the term of the loan until the full principal and interest came due about one year after the loan. Petitioner did not learn that the stock shares he had pledged to the bank were "restricted" until just prior to the due date, in August or September of 1987. When the bank informed him, the petitioner was "shocked" (App.

pp. 14-15).

A few months previously, petitioner had also obtained a second loan from the bank, a consumer loan for $13,200. The Bankruptcy Court held that this $13,200 loan to be dischargeable because there was no indication that any of the Applied Optics shares were pledged as collateral (App. pp. 48-50).

Concerning the first loan of $50,000, however, the Bankruptcy Court held that it was not dischargeable on the grounds that the petitioner "fraudulently" failed to disclose existing stock restrictions. The Court ruled that Mr. Hecker showed a "reckless

disregard of the truth", from which the Bankruptcy Court declared, "an intent to deceive may be found" (App. pp. 54-57). The Court also found that the bank reasonably relied on the petitioner's pledge of his shares of stock (App. pp. 61-63).

Finally, the Bankruptcy Court found that the bank sustained a loss as a proximate result of petitioner's alleged misrepresentation of omission (failure the disclose stock restrictions) because almost all the shares pledged were restricted at the time of default on October 2, 1987. The Bankruptcy Court ignored the issue of the stock share's

salability and value until its subsequent "Decision Granting Motion To Amend" (App. pp. 83-85).

The Bankruptcy Court awarded the bank $50,000, plus interest, and 15% attorney's fees, a total of $64,761.10. The Court had originally awarded only the value of the shares at the time of the default, plus attorney's fees. Later, the Court reversed itself (App. pp. 70-90).

Petitioner now seeks review of the non-discharge of his $50,000 loan obligation.

ARGUMENT IN FAVOR OF ALLOWANCE OF WRIT

THE WRIT SHOULD BE GRANTED BECAUSE, IN GENERAL, IN A TIME OF ECONOMIC RECESSION AND BANK FAILURES, THE PARAMETERS OF BANKRUPTCY DISCHARGE EXCEPTIONS AND RIGHTS OF GOOD FAITH HOLDERS OF RESTRICTED STOCK AS COLLATERAL HAVE PARTICULAR IMPORTANCE; MORE SPECIFICALLY THE COURT HAS THE OPPORTUNITY HEREIN TO DETERMINE HOW STRICTLY THE DISCHARGE EXCEPTION OF 11 USC § 523(a)(2)(A) SHOULD BE CONSTRUED, AND TO CLEAR UP THE CONFLICT AMONG AND WITHIN THE CIRCUITS ON THE REASONABLE RELIANCE REQUIREMENT.

A. The Burden Of Proof Is On The Creditor To Prove By Clear And Convincing Evidence Each Of The Elements Of Any Exception To Discharge (Here "Fraud"); The

Creditor's Evidence In The Bankruptcy Court Trial Failed To Establish "Fraud".

To prove the 11 U.S.C. 523(a)(2)(A) exception to discharge, a creditor (such as the respondent bank here) must show in Bankruptcy Court: (1) that the debtor [petitioner here] made a representation or statement, (2) that it was false, (3) that it was made with intent to deceive, and (4) with either actual knowledge that it was false or gross recklessness as to its truth, (5) that respondent relied on it, (6) that reliance was reasonable, (7) that the creditor [respondent] suffered a loss, and

(8) that loss was proximately caused by debtor's conduct. In Re Nahas, 92 B.R. 726 (E.D. Mich. 1988).

The creditor must prove all of the elements of the test for fraud, by a preponderance of the evidence. Grogan v. Garner, 111 S. Ct. 654, 112 L.Ed. 2d 755 (1991). Exceptions to discharge are to be construed strictly. In Re Jackson, 89 B.R. 308, 313 (Bankr. D. Mass. 1988). This resistance to discharge exceptions is used to afford the debtor a "fresh start." See: Local Loan Co. v. Hunt, 292 U.S. 234, 54 S. Ct. 695, 78 L.Ed 1230 (1934).

1. The Trial Evidence Was Not Legally Sufficient To Establish

"Fraud" Because Petitioner Never Made Any False Statement or Willful Misrepresentation.

The Bankruptcy Judge ruled petitioner's false representation or willful misrepresentation was that the petitioner "recklessly" pledged stock shares to the bank which were not restricted. (App. pp. 52-57) The Bankruptcy Judge's ruling on this point was clearly erroneous, inter alia, because he used the term, "reckless", and did not find gross recklessness as required. In Re Nahas, supra. That is, a review of the evidence shows that whatever mistakes petitioner might have made, he did not engage in the moral

equivalent of driving 65 miles per hour in a 20 mile-per- hour school zone with children present.

Further, the Bankruptcy Judge misstated the issue. The bank was not concerned with the technicalities of the stock restrictions, only with receiving stock shares with sufficient value as collateral for the loan. The bank officer said he would not have made the loan without some adequate security. See App. p. 7.

The Bankruptcy Judge erroneously stated in his opinion: "If the stocks were restricted, they couldn't be pledged...." App. p. 56. Although SEC Rule 144 and the Shareholders Agreement (App. pp.

114-115) executed as part of the public offering transaction generally banned stock pledges for a certain period, the remedies for such transgressions would include enhanced liabilities for petitioner, but would not adversely affect the bank as a bona fide recipient of the stock as collateral (unless petitioner's March, 1986 financial statement showing the shares as restricted would take the bank out of this status-App. p. 21). As stated in ADM Corp. v. Thomson, 707 F.2d 25, 27 (1st Cir. 1983), "The Securities Act does not by its terms automatically invalidate sales of unregistered securities in violation of § 5. Rather, when unregistered

securities are sold illegally, the Act simply grants the buyer a remedy, § 12(1). 15 USC § 771(1)."

Thus, such restricted shares in a private transaction with a sophisticated party such as a bank can have value. Edina State Bank v. Mr. Steak, Inc., 487 F.2d 640 (10th Cir. 1974). As a result, the true issue at trial was not the presence or absence of restrictions at all, but whether the (restricted) shares had collateral value. The bank having the burden of proof never offered evidence on this value, nor any attempt to sell the stock, and thus, no evidence as to why not. See App. p. 69. The Bankruptcy Judge, therefore, erred, when he

stated, "...upon the Bank's inquiry...it was determined that the shares could not be sold." App. p. 83.

Finally, petitioner could not "misrepresent" facts of which the bank was aware. That is, petitioner submitted just six months before the loan transaction at issue, a financial statement the bank officer testified he used to make the loan, disclosing the restrictions. (App. pp. 7-9)

2. The Bankruptcy Judge Could Not Make A Legally Sufficient Finding Of "Fraud" Because There Was

No Required "Intent To Deceive," Since Corporate Counsel Sanctioned the Transaction.

The trial evidence was not sufficient to sustain a finding of "intent to deceive" for two reasons: (1) As stated in section 1. immediately above, the stock which petitioner pledged did have value, which the bank never proved was insufficient; the bank was concerned with collateral value, not restrictions (See App. p. 7); (2) the whole loan idea originated from Applied Optics' counsel, who in effect provided his unqualified opinion to petitioner that he should and could pledge the Applied Optics

stock shares at issue.

The Bankruptcy Judge himself acknowledged that corporate counsel originated the entire loan concept (App. pp. 45-48) and that petitioner did consult corporate counsel about pledging the shares (App. pp. 45-48). Petitioner testified he was aware of possible restrictions (App. pp. 11-12), but understood that no restrictions applied, since corporate counsel advised him to pledge the stock (App. pp. 22-25). Indeed, petitioner's understanding was eminently reasonable because the terms of the stock restriction provided that transfers (including, of course, pledges) were permissible in the case of "a favorable opinion

of its [Applied Optics'] legal counsel". See App. pp. 114-115. At the same time, petitioner was not experienced at public offerings and his knowledge in this regard was quite limited. (App. pp. 16-20).

Meanwhile, substantial legal authority supports petitioner in his assertion that "intent to deceive" cannot be found where the debtor reasonably relies on the best "available source of knowledge". Morimura v. Taback, 279 U.S. 24, 33 (1929). What more could the petitioner possibly do to verify the stock restriction transaction than to consult the attorney who supervised the corporation's public stock offering and originated the

concept of the petitioner's stock pledge? See: O'Reilly v. Endicott, 297 F.2d 1 (1961); Kentile Floors, Inc. v. Winham, 440 F.2d 1128 (9th Cir. 1971) (Discharge upheld in circumstances of bookkeeper error and misrepresentation of legal advice); In Re Jackson, supra. (Discharge upheld in circumstances of accountant and attorney advice).

3. Petitioner cannot be said to have acted with knowledge of, or gross recklessness as to the truth of, either the restrictions or the actual share value.

As to the "knowledge" element, the Bankruptcy Judge found against petitioner on the basis of ignoring the possible continuing validity of stock restrictions and proceeding with "reckless disregard of the truth" (App. pp. 54-57) As stated, the Bankruptcy Judge (impermissibly) failed to make a finding of "gross recklessness", as characterized In re Nahas, supra. In the absence of actual knowledge, the requirements of gross recklessness, as opposed to

"ordinary" recklessness, is consistent with the "fresh start" principle. Further, the Bankruptcy Judge's "reckless" finding flies in the face of petitioner's consultation of the best possible source on the legal status of the corporation's stock shares, the corporate attorney.

On the other hand, based on the discussion above concerning the Bankruptcy Judge's legal error when he assumed lack of value of the restricted shares, we must also consider petitioner's knowledge of the value of the shares, assuming restrictions. That is, the Bankruptcy Judge erroneously stated "If the stocks were restricted, they

couldn't be pledged, and the debtor necessarily would be aware that he was misleading the bank...." App. p. 56. We have already demonstrated above that restricted shares could be pledged with a favorable opinion from counsel, that even restricted shares have value, and that bank representatives testified at trial that they were only concerned with the value of the collateral, not the precise legal posture of the shares.

Meanwhile, the bank introduced no trial evidence on the actual value of the shares, as restricted, despite its having the burden of proof. Therefore, no matter what knowledge petitioner did or did not

have about restrictions, an essential element of the bank's required proof of petitioner's knowledge is missing, actual value of the stock, even if restricted. As long as the shares were sufficiently valuable to serve as collateral, petitioner's conduct cannot be fraudulent as he would necessarily have no knowledge whatsoever of the unsuitability of the shares as collateral.

4. Assuming Misrepresentation Did Occur, The Bank Failed To Demonstrate Actual or "Reasonable" Reliance (Which Is The Subject Of Conflicts Within And Among Circuits)

The bank's representatives at trial testified only that the bank sought sufficient collateral value of the shares, not whether or not restrictions made any difference. The bank representative's exact words were, "I would not have made the loan if we did not have the stock certificate, the value of the stock...of the $50,000" (App. p. 7). There was no other testimony on this point.

Having the burden of proof,

the bank did not prove anything more than its concern about stock value, not restrictions. Thus, there was no proof that the bank actually relied on the purported petitioner's misrepresentation about stock restrictions, nor any proof that the actual value was less than the $50,000 desired.

Even if misrepresentation as to stock restrictions is found and the bank actually relied on such misrepresentations about restrictions, this reliance must also be "reasonable" to establish the 11 U.S.C. § 523(a)(2)(A) fraud exception, in the view of most federal courts. Some courts, however, do not impose any

requirement of reliance being "reasonable" in applying Section 523(a)(2)(A). See In Re Phillips, 804 F.2d 930, 932-33 (6th Cir. 1986), citing In Re Sobel, 37 B.R. 780, 785-86 (Bankr. E.D.N.Y., 1984) and In Re Fosco 14 B.R. 918, 921-23 (Bankr. D. Conn. 1981). See also In Re Ophaug, 827 F.2d 340 (8th Cir. 1987) and In Re Showalter, 86 B.R. 877 (Bankr. W.D. Va. 1988).

In the Eleventh Circuit there is uncertainty and even conflict on this issue of whether reliance must be reasonable. See In Re Firestone, 26 B.R. 706 (Bankr. S.D. Fla. 1982) (Court uncertain about "reasonable" reliance requirement, but probably no such requirement), and In Re

Lilienfield, 36 B.R. 724 (Bankr. S.D. Fla. 1984) and In Re Wise, 6 B.R. 867 (Bankr. M.D. Fla. 1980) ("reasonable" reliance is required).

There is a similar, yet sharper, conflict in the Second Circuit. While In Re Fosco, and In Re Sobel, supra, make no requirement of "reasonable" reliance, In Re Newmark, 20 B.R. 842, 861-862 (Bankr. E.D.N.Y. 1982) holds that the "fresh start" doctrine requires rigorous proof from the creditor that reliance was "reasonable".

The "rigorous" view is shared by the Tenth Circuit. See In Re Mullet, 817 F.2d 677 (10th Cir. 1987). In contrast, the Sixth Circuit (In Re Phillips, supra) and

the Seventh Circuit (In Re Garman, 643 F.2d 1252 (7th Cir. 1980)) have adopted the "reasonable" reliance requirement, but do not require rigorous creditor proof. The creditor fails to establish "reasonable" reliance when "a creditor's claimed 'reliance'.... would be so unreasonable as not to be actual reliance at all." In Re Garman, supra, at p. 1256.

Even in such "low threshold" reasonable reliance jurisdictions, the creditor has been held unable to establish "reasonable" reliance. See for example, In Re Ward, 857 F.2d 1082 (6th Cir. 1988). In that case, a discharge exception for "fraud" was denied when a bank

failed to check the credit history of the debtor, which would have revealed massive difficulties. The court quoted (at p. 1084) In Re Mullet, supra, in support of its position as follows: "In cases where 'minimal investigation and verification almost certainly would have uncovered the falsity of the representation,' a bank's debt must be discharged if no such investigation had been performed."

In the present case, the bank never conducted even a minimal investigation into the stock's suitability for a pledge, nor ever checked the corporation's SEC filing to ascertain whether or not the stock was restricted (which could

have been required at the borrower's expense) (App. pp. 7-11). The bank did not even ask Mr. Hecker, or anyone else, (such as the corporate attorney) whether there might be encumbrances or restrictions on the stock. App. p. 9.

Further, respondent made loan in spite of the petitioner's financial statement at the bank, which listed the stock as "restricted". App. p. 7-8. Finally, the bank completely ignored SEC regulations which imposed restrictions on Mr. Hecker's stock as part of a public offering, although it had been dealing with Mr. Hecker for many months and knew his corporate status. SEC Reg. §

230.144, Securities Act of 1933 (Rule 144), 17 C.F.R. § 230.144

Hence, the respondent did not use ordinary care in a loan to petitioner when it had investigative resources available to it requiring minimal or no expense. Indeed, given the bank's failure to establish at trial that the pledged stock had inadequate collateral value, it can be argued effectively there was in fact no reliance on the purported misrepresentations about restrictions.

5. The Bank Also Failed to Establish The Final Element of the Fraud Exception, That the Alleged Misrepresentations Were The Proximate Case of the Loss

We have established herein that the bank could have sold the shares at issue. At the same time, we have discussed how the bank never made any attempt to sell the stock, while never explaining why. (App. p. 69). Thus, the bank, bearing the burden of proof, never supplied a link in its proof necessary to sustain a finding of fraud: that the value of the saleable collateral stock was insufficient to cover its loss.

B. Conclusion

The writ should be granted because of the opportunity for this Court to define the parameters of the "fraud" exception to bankruptcy discharge, particularly in Section 523(a)(2)(A) cases. The Court can also address an important securities issue, whether a bona fide, good faith recipient of restricted publicly-traded stock as collateral is entitled to liquidate the security on default, free of the restrictions. Still further, the Court would have a prime opportunity to settle the law on "reasonable" reliance, should the Court find against petitioner's powerful

argument that he never engaged in "fraud" in the first place. Petitioner relied on corporate counsel and did pledge saleable stock of some significant value, very possibly sufficient in collateral value to cover the loss. That value was never established at trial, despite the bank's burden of proof. Whatever the value, the conduct of a debtor such as this petitioner cannot be adjudged "fraud" where pledged stock shares, though restricted, were saleable and did have value.

Respectfully submitted,

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Admitted: August 20, 1979

CERTIFICATE OF SERVICE

I, Christopher A. Teras, do hereby certify that three copies of the foregoing Petition for Writ of Certiorari, together with the Appendix thereto, was on January 21, 1992 duly deposited in the United States Mail, postage prepaid, addressed to:

M. Michael Cramer, Esq.
Attorney for Respondent
Cramer & Klopman Chartered
216 North Adams Street
Rockville, MD 20850
(301)424-0677

_____
Christopher A. Teras

Supreme Court, U.S.
FILED
JAN 21 1992
OFFICE OF THE CLERK

No.

IN THE UNITED STATES SUPREME COURT

OCTOBER TERM, 1991

RICHARD P. HECKER, Petitioner

v.

FRANKLIN NATIONAL BANK, Respondent

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA
CIRCUIT, NO. 89-7255

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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United States Court of Appeals

For the District of Columbia Circuit

Richard P. Hecker,

Appellant,

v.

Franklin National Bank

of Washington, D.C.

Case no. 89-7255

APPEAL FROM THE UNITED STATES

DISTRICT COURT FOR

THE DISTRICT OF COLUMBIA

Before: Mikva, Chief Judge;

Williams and Randolph,

Circuit Judges

JUDGMENT

This case was considered on appeal from the United States District Court for the District of

Columbia and on the briefs filed by the parties and arguments by counsel. The arguments have been accorded full consideration by the court and occasion no need for a published opinion. See D.C. Cir. Rule 14(c).

Appellant contends that the District Court erred in affirming the Bankruptcy Court's ruling that a $50,000 loan advanced by the predecessor-in-interest of appellee Franklin National Bank was not dischargeable in bankruptcy under U.S.C. § 523(a)(2)(A). Appellant had argued below that the Bankruptcy Court's factual findings were clearly erroneous and that the Bankruptcy Court misapplied the

legal test used to determine whether appellee reasonable relied upon appellant's alleged false representation. We affirm, essentially for the reasons discussed in the District Court's Memorandum Opinion, filed September 25, 1989. Any error in the district court's concept of reasonable reliance (assuming any such requirement was applicable) was not unfavorable to the bankrupt, and its finding of reasonable reliance was not clearly erroneous.

ORDERED and ADJUDGED that the Order affirming the Bankruptcy Court's ruling is affirmed.

The clerk is directed to withhold issuance of the mandate

herein until seven days after disposition of any timely petition for rehearing. See D.C. Cir. Rule 15.

Per Curiam

For the Court

Constance L. Dupré

Clerk

UNITED STATES BANKRUPTCY COURT

DISTRICT OF COLUMBIA

FIRST INTESTATE BANK OF

WASHINGTON, D.C., N.A.

USBC NO. 88-0274

4AP NO. 88-0021

Transcript of Trial

November 21, 1988

Transcript Page 14

Q Okay. Now there came a time that a second loan was made, is that correct?

A Yes, sir.

Q I am giving you Plaintiff's Exhibit number 4. Please look and examine Plaintiff's Exhibit 4 and I ask you to tell us what it is?

A It is an installment loan from the bank to Richard Hecker

Q When was that given to the bank?

A June 3rd, 1987.

Transcript Page 16

BY MR. CRAMER:

Q Please tell us, sir.

A I would not have made the loan if we did not have the stock certificate, the value of the stock.

Transcript Page 17

Q Of the $50,000.

A Of the $50,000.

Transcript Page 25

Q Before you made a loan, would you go back and review financial statements?

A Yes, I would.

Transcript Page 26

Q To see if there had been a change in position?

A Correct.

Q It would be important, wouldn't it? To make sure there wasn't any decrease any changes in the financial position that might alert the bank to problems?

A I would review other documents, yes, including the previous financial statements.

Q Did you ever ask Richard Hecker if the stock which he was pledging was restricted?

A I don't recall if I did or not.

Q. Did you ever call up the president of Applied Optics and ask him if the stock was restricted?

A I don't know if I used the term--

Q Prior to making the loan.

A Oh, prior to making the loan?

Q Yes

A I don't think I did. I don't recall.

Q Prior to making the loan, did you call up the attorney for Applied Optics as ask him if the stock was restricted?

A I don't believe I did. I saw that he had stocks available on his financial statement.

Q Did you, prior to the--prior to making the loan, go down the street to the Securities and Exchange Commission and see if there was any restriction on officers ability to pledge stock?

Transcript Page 27

A No, I didn't do that. I know I didn't do that, no.

Q Did you do anything prior to making the loan, other then reviewing the face of the stock certificate to make sure that that stock had validly been issued to Richard Hecker?

A I reviewed the stock certificate, which bore the corporate seal. I obtained a stock power, and I assessed the value of the stock.

Q How did you assess the value?

A In the Wall Street Journal and the bank--next door to the bank in the same building is an office of Charles Schwab. I went next door and checked it on the terminal.

Q You checked it on the terminal?

A Using its symbol.

Q You put the corporate symbol in?

A Right.

Q How did you know Applied Optics corporate symbol?

A I don't know how I determined that, but maybe it was in the standard reports. I am not sure.

Q You didn't check any stock ledgers to make sure the stock was validly issued to Mr. Hecker, did you?

A Stock Ledger?

Q The corporation's stock ledger?

A No, the corporate seal, I served as sufficient.

Transcript Page 45

Answer: In the course of our S-18 registration, when we were taking the company public, the attorney Tom

Prousalis who took us public, said our stock would be restricted. This is that I recall. Our stock would be restricted for a period, I thought, of 24 months/30 months; that in the course of a public registration, when you are working on the prospectuses, and investor pamphlets and things like that, you tend to be talking from the date the company was founded in December of '83, I think December 16th, '83. When our stock was issued, officially issued, with certificates, I believed the restriction was from the date of incorporation."

Transcript Page 48

Q "Did you in fact receive $50,000

from National Enterprise Bank when you applied for it?

A "Yes, I did."

Continuing on to page 57, and the bottom of page 56:

What did you do with the $50,000?

"I lent it to the company, and also bought some stock in the company's name.

Transcript Page 50

Q. I thought you said before, that you were having problems getting paid until you borrowed the $50,000 which you lent to Applied Optics, then they could pay you?

A I believe you said that. I may have agreed to it. Mr. Cramer, it is very difficult to remember when you

were getting paid and when you weren't letting paid. I don't really--

Q Did the $50,000 that you borrowed from National Enterprise Bank, in fact help you get paid?

a I'm sure it did.

Q Because times were financially rough at that time?

A Yes.

Transcript Page 54

Q Did you, in fact, learn at any time that this stock, the 75,000 shares, represented by Exhibit 1, was in fact restricted?

A Yes

Q When did you learn that?

A Approximately August or September of last year, of '87, I had a

conversation with Bill O'Neill.

Q And He told you that?

A Yes.

Q And you were shocked?

A Yes, I'm sure, Yes.

Transcript Page 56

On page 105, restriction on transfer, "shareholders executing this agreement agree not to sell, pledge, hypothecate, donate or otherwise transfer any of their shares of common stock, prior to the end of a 36 month period, commencing from the effective date of the S-18 registration statement filed by the company with the Securities and Exchange Commission, Washington,D.C., for the sale of the company common stock to the public."

The form, the first page, is S-18 statement. In other words, it is entitled "Securities and Exchange Commission Form S-18, registration statement" filed August 22nd, 1985, and with the attachments is this agreement.

I also proffer, Your Honor, that the agreement is signed by five shareholders, one of them being Richard P. Hecker, attached on the left side, Richard P. Hecker, secretary.

Transcript Page 66

Q When did you join Applied Optics?

A I joined Applied Optics March 1st, 1985.

Q What does Applied Optics do?

A They are a manufacturer of contact lens.

Q They are what?

A They are a manufacturer of contact lenses.

Q What did you do before you joined Applied Optics?

A I was the managing partner of a small life and health insurance agency.

Q What did you do before that?

A I was the personnel director of a hospital in Dayton, Ohio.

Q What was your position with Applied Optics?

A The position was executive vice president, secretary/treasurer.

Q Now when you started, was Applied Optics a public corporation?

A No, it was not.

THE COURT: Just a minute. You were secretary/treasurer and what else?

THE WITNESS: Executive Vice President.

Transcript Page 67

THE COURT: Go ahead.

By Mr. Kearney:

Q Was Applied Optics a public corporation at the time you joined it?

A No, it was not.

Q When did it go public?

A I believe the public offering was September 26th or 28th of 1985. I don't remember the exact date.

Q Who handled the public offering?

A Our corporate attorney handled

most of the SEC registration material, investor relations, those kind of things. I was involved in-- to a limited extent, in working on the prospectus as far as describing the nature of the business.

Q What was your attorney's name?

A His name was Thomas Prousalis.

Transcript Page 69

Q Is that July 24, 1985?

A Yes, it is.

Q Where were you when you signed that document?

A To be honest with you, I don't know where I was at that time.

Q Do you recall signing that document?

A No, not really.

Q How many documents do you have to

sign for the public offering?

A In the course of our S-18 registration, I signed at least 150 to 200 documents.

Q How carefully did you read each document?

A I probably did not very carefully read very many of them.

Q Did you read page by page, skim, or just sign.

A Basically, I just signed.

Q Who prepared the documents?

A At the time, our corporate attorney did, Tom Prousalis.

Q How much training do you have in securities law?

Transcript Page 70

A I have no training.

Q How many other corporations have

you participated in going public, prior to this one?

A None.

Transcript Page 73

A This is a financial statement I prepared for the bank.

Q When did you prepare it?

A March 3rd, 1986.

Q Turn to the page, the back page.

A Yes

Q Under where it lists the stock you own.

A Yes.

Transcript Page 74

Q Well, did you tell the bank about this reverse stock split?

A Yes, we did.

Q When did you do that?

A Bill O'Neill was on our mailing list, and we used to keep him apprised of news releases and affairs of the company. We would send a news release out to him or our quarterly financial statements.

Transcript Page 75

Q Was the stock that you pledged, the 75,000 shares, actually restricted?

A I have subsequently found out that it is, yes.

Q Mr. Hecker, why would you pledge restricted stock?

A At the time I pledged the stock, I did not realize it was restricted.

Q Why is that?

A Because I had pledged the stock under the--with the

knowledge of my corporate attorney at the time, who had recommended that I use the stock as collateral--

MR. CRAMER: Objection, Your Honor.

THE COURT: Overruled.

THE WITNESS: --who recommended that I use the stock as collateral in order to secure a loan for the company so that we could purchase--the corporation itself could purchase stock in the marketplace in the OCT.

BY MR. KEARNEY:

Q So it wasn't your idea to pledge the stock.

MR. CRAMER: Objection.

THE COURT: Sustained. He

recommended to you the stock as cash collateral to put the money into the corporation so that the company could buy stock?

THE WITNESS: We had a small amount of stock that was available to the public. Our corporate attorney advised us to have a press release saying that from time to time the corporation could buy stock, buy back some of its stock from the public to help support the price of the stock.

At the time, I said to him, the corporation is not a financial position to do that. And he said, why don't you try to borrow, personally, to see if you can get some money and lend it to the

company. I said, I don't own property at that time. I don't have any collateral. He said, you can use your stock certificate as collateral.

Transcript Page 77

He gave me the certificate. I approached the bank, and got the loan.

Transcript Page 107

THE COURT: The Court is going to announce its findings of fact and conclusions of law in this adversary proceeding at this time.

Transcript Page 108

In March of 1985, the defendant, Richard P. Hecker, whom I will occasionally refer to as the debtor, became an officer of Applied

Optics Incorporated.

At that time, Applied was a privately held corporation. During the summer and fall of 1985, applied went public and became trded as an over the counter stock.

On July the 24th, 1985, the debtor executed a shareholders agreement agreeing that his shares in the company, which he had received upon joining the company in 1985, would not be pledged nor traded for a period of three years, after the filing of a Form S-18, a registration statement with the Securities and Exchange Commission. (See Exhibit number 2 for the plaintiff.)

The registration statement was

eventually filed on August 22, 1985. (Plaintiff's Exhibit number 2.) On July 30th, 1985, the debtor who had a standing lending relationship with National Enterprise Bank, the predecessor to the plaintiff in this adversary proceeding, wrote a letter to the lending officer advising him of the public offering.

On September the 27th, 1985, the prospectus for the public offering was issued. (Plaintiff's Exhibit number 9.) on March 3rd, 1986, the debtor submitted a financial statement to the company reflecting his ownership of 17,500,000 shares of Applied Optics as restricted shares.

Transcript Page 109

These shares were eventually converted into 75,000 shares of the company and 100,000 warrants of the company when the company eventually underwent a 1 for 100 reverse stock dividend.

The financial statement, which is Defendant's Exhibit number 1-A, also lists another 175,000 in unrestricted stock that the debtor had purchased in the public market.

On Mach the 19th, 1986, the certificate that is at issue in this case (Plaintiff's Exhibit number 6) was issued to the debtor. The date of the issuance may have actually been placed upon the document after signatures were affixed to the

document; but that is the actual date placed upon the document.

The certificate was issued as part of the reverse stock split previously referred to by the Court at a time that the company was trying to assure that its stock would be more easily traded in the over the counter market.

The certificate was retained by the attorney for the company, Tom Prousalis, at his office, until the debtor called upon Mr. Prousalis to turn the certificate over to him in the fall of 1986, when the loan that is the subject of this adversary proceeding was granted to the debtor.

The debtor testified that he

signed the certificate in the fall of 1985 when the company closed the public offering; that he did not recall signing any certificates

Transcript Page 110

after that time, and that the stock certificates remained in the possession of Tom Prousalis until he called upon Mr. Prousalis to hand them over to him for purposes of his obtaining a loan.

Now, at the same time that the company was doing the reverse stock split in March of '86,and within a couple of months thereafter, in April and May of 1986, the debtor engaged in trying to raise funds for the company through private placements, and at that time, signed

stock certificates for investors.

When the debtor came on to the Applied Optics Company in March of 1985, to become its chief money raiser. In addition, he carried on duties in charge of payroll, purchasing and personnel.

Prior to that time, prior to becoming employed with Applied Optics Incorporated, the debtor had been engaged in the insurance business. He was licensed to sell insurance in 10 to 15 states. He had taken the Maryland test. He had worked in the insurance business with difficult contracts and it was through his insurance business that he eventually met Robert Breece, one of the principals of Applied Optics

Incorporated, when he attempted to sell Mr. Breece insurance.

In the course of attempting to sell stock to private placement investors, Mr. Hecker had conversations with

Transcript Page 111

some of the investors concerning the restrictions upon the stock. He, of course, informed them that the stock could not be sold for some time, and he was well aware of the restrictions that existed with respect to the sale of private placement stock.

In August of 1986, the debtor engaged in another private placement of stock on behalf of Applied Optics, Inc. In the course of that,

of course, had the same types of conversations with investors concerning possible restrictions upon the stock -- actual restrictions upon the stock's salability after its issuance.

In September of 1986, September the 23rd of 1986, the debtor wrote to the loan officer at National Enterprise Bank and apprised him that his attorney Tom Prousalis would pledge a stock certificate incident to a proposed loan that was being considered at that time.

In September of 1986, Mr.Prousalis turned over the stock certificates belonging to Mr. Hecker, who in turn turned them over to the bank incident to a secured

loan that is the primary subject of this adversary proceeding.

That occurred on October 3rd, 1986, when the debtor signed a promissory note, which has been marked as Plaintiff's Exhibit number 3.

On June 3rd, 1987, the debtor obtained a second note from the bank, signing a promissory note for $13,200.

Transcript Page 112

The amounts owed pursuant to these loans, as of today,is $56,314.06 with respect t the promissory note for $50,000, plus reasonable attorney's fees of 15 percent. With respect to the second loan, $13,704.37 is owed, together with

attorney's fees of 15 percent.

Mr. Hecker met with William O'Neill, an employee of National Enterprise Bank and a lending officer, to obtain the first loan of $50,000. The bank had prior dealings with Mr. Hecker and Mr. O'Neill was well aware that the bank had prior -- that Mr. Hecker's corporation for which he worked, Applied Optics, Inc., had dealings with the bank in the past.

Before making any loan, Mr. O'Neill insisted upon, or at least requested security. He obtain what is Exhibit number 6 for the plaintiff, the stock certificate worth 75,000 shares dated March 19, 1986.

Based on the receipt of that stock certificate, which included an irrevocable stock or bond power signed by the debtor,the bank National Enterprise Bank issued a $50,000 loan to the debtor.

The bank would not have made the loan without the receipt of this security. At the time the loan was obtained, the stock of Applied Optics Incorporated was trading at a publicly traded value such that if Plaintiff's Exhibit 6, the 75,000 shares in Mr. Hecker's name were not restricted

Transcript Page 113

shares, they would have been worth $170,000 or in excess of the amount of the loan being secured.

The loan was not made until Mr. O'Neill first ascertained the current shaded value of the company, both through the Wall Street Journal and through a local stock brokerage firm.

At the time of the receipt of the stock certificate, Plaintiff's Exhibit 6, and all times prior thereto, and before the issuance of the disbursement of the funds pursuant to the loan, Mr. O'Neill was never told that this stock certificate represented restricted shares of Applied Optics Incorporated.

By reason of the restrictions, the stock was not properly the subject of a pledge, and could not

be transferred by the debtor.

The note matured in October of 1987, at which time the bank learned that the stock was restricted and it could not realize upon this collateral.

Now, the second loan, the $13,000 was made in June of 1987, and no additional security was taken at that time. The loan documents themselves --the promissory notes themselves, Plaintiff's Exhibits 3 and 4, control the question of whether these notes, whether the second note was secured by the stock that had been previously pledged. In addition to the stock pledged, the 75,000 shares pledged, the debtor

pledged an additional 775 shares representing the shares he had purchased on the public market, and which were listed as 7,750 shares in his financial statement of March of 1986, prior to the reverse stock dividend.

The first promissory note, Plaintiff's Exhibit number 3, included a security agreement stating that "the bank is granted a security interest in the collateral described on the reverse side hereof, and in the proceeds thereof. This security interest will be collateral security for the payment of this note and for any extensions

or renewals thereof, and of all other obligations of each party to the bank, direct or contingent, due or to become due, whether now existing or hereafter arising, except," and the Court would underline the clause beginning except, "consumer credits subject to the disclosure requirements of the Federal truth in lending act, unless an express security interest in the collateral is granted under the terms of such consumer credit."

Plaintiff's Exhibit number 4, the promissory note for the later loan of $13,200 was styled a consumer note in truth and lending disclosure statement. There has been no dispute that it, in fact,

was a consumer loan, and the document contains a paragraph six, entitled "security" wherein the debtor had the option of checking boxes stating whether he was giving the bank a security interest in any property.

The document was left completely blank with

respect to this; in other words, the debtor did not indicate in any fashion that he was giving any security interest in any property.

With respect to Defendant's Exhibit 1-A, the financial statement of March 1, 19856, signed by the debtor on March 3, 1986, there is no evidence that the bank in fact

examined the financial statement when making the subject loan. The bank did not take any additional financial statement in obtaining the -- in issuing the loan of $50,000.

The bank took no steps to ascertain whether Richard Hecker's 75,000 shares being pledged were, in fact, restricted or not. They never inquired of Richard Hecker or anyone else concerning whether they were restricted. They never went to the Securities and Exchange Commission. They never inquired of the company or of the company's attorney whether these were restricted shares.

Mr. O'Brien was satisfied that the stock certificate -- that the stock certificate, Plaintiff's

Exhibit number 6, the 75,000 share stock certificate, had a corporate seal upon it and appeared to be shares of a company that were being traded over the public -- in the public market pursuant to the over the counter market.

The plaintiff bank, National -- the predecessor of the plaintiff bank, National Enterprise Bank, was, at the time, a small bank when it made the loans to Mr. Hecker.

Transcript Page 116

It has approximately $32 million in outstanding loans.

With respect to the receipt of pledged stock of publicly traded company, the bank's procedure was to insure that the stock had a

corporate seal upon it. The bank did not have any procedures for checking whether the stock was, in fact, restricted or not, if it did not have a restriction legend upon the face of the stock.

The certificate for 75,000 shares had its genesis, the Court will note again, in the debtor's initial employment with the Applied Optics, Incorporated, company. He received the shares when he came on to the company in March of 1985, as an inducement to come with the company; and they represented approximately 10 percent of the stock of the company.

In respect to the public offering of the company stock, the

debtor was the primary person dealing with Thomas Prousalis n preparation of the papers for the private placement for the public offering. He was required to sign numerous documents in the course of the public offering.

The debtor, nevertheless, was well aware of the distinction between publicly traded stock and restricted shares. He was aware, for example, of the distinction between what has been marked Plaintiff's Exhibit 5 and Plaintiff's Exhibit number 6, in terms of the source of the issuance of those shares. Plaintiff's Exhibit number 5 is a share

issued by the company itself internally to founders and select investors that, as the debtor put it, was nicer looking and bears an impressed seal. It bears an actual signature of the secretary and the president, and was in the debtor's words, "nicer looking."

Exhibit number 5, in contract, one of the publicly traded shares of the company, is -- does not bear a raised seal; does not bear an actual signature of the secretary or president of the company, but a facsimile thereof, and contains a transfer agent authorized signature.

Incident to the public offering, the debtor kept Mr. O'Neill of the bank apprised of the

ongoing public financing, as indicated by the previous letter of September of 1986, and also by the fact that Mr. O'Neill was kept on the company's quarterly mailing list for quarterly financial statements and new releases.

Mr. Hecker's company, Applied Optics, Inc., in the fall of 1986 was in a position where it could not itself raise conditional loaned monies, and in order to assist the company in buying stock on the open market, to stabilize the price of the stock of the company, it was suggested to Mr.Hecker by his attorney -- by the attorney for the company, Thomas Prousalis, that he might pledge his shares of stock

with the bank in order to raise the funds that the company could then use to stabilize its stock.

Transcript Page 118

A substantial part of the $50,000 loan was, indeed, used for that purpose, went to the company and used to buy back stock of the company and had the side benefit of allowing the company to more easily meet some of its payroll needs as well.

The debtor obviously believed that the company would eventually succeed in its endeavors, if the momentary financial difficulties, if they could be characterized as that,

would pass by; and unfortunately his hopes did not bear fruit.

For all of the year of 1987, the company's stock had plummeted in value, and in 1987, late 1987 or in 1988 the company itself went into bankruptcy and the stock was trading at a negligible value.

The debtor, I think, testified that the amount is approximately 25 cents a share.

The easy issue in this case is the loan of $13,200. With respect to that loan, the bank was not entitled to rely upon the previously pledged stock certificate of 75,000 shares, because by its terms the security interest previously granted did not reach the consumer note loan

represented by the $13,200 promissory note.

The consumer loan document did not include any security benefit interest upon its face, and the previous security interest document clearly excluded consumer loans

Transcript Page 119

from its coverage.

For that reason, the Court must conclude that the loan of $13,200 is not a -- is not a non-dischargeable debt, and the debt is dischargeable.

With respect to the $50,000 loan, the issue is much more difficult and before I announce my conclusions I want to say that with competent counsel of the caliber that were present here today, I

should have known that this was going to be a difficult issue.

The elements -- the statute invoked for non-dischargeability by the bank, Section 523A-2(a) of the Bankruptcy Code, and I don't think there is much disagreement concerning the elements of that statute, what must be proven in order for the bank to prevail.

In the case of In Re Mullet, 817 F.2d 677, page 680, 10th Circuit 1987, the Court, for example, stated that the bank must show -- let me indicate that this is a quote: "the bank must thus prove each element necessary to prevent the discharge pursuant to Section 523A-2(a): the debtor made a false representation

and willful misrepresentation; the representation was made with the intent to deceive the creditor; the creditor relied on the representation; the creditor's reliance was reasonable; and the creditor sustained a loss as a result of the debtor's representation."

The first element is whether the debtor made

Transcript Page 120

a false representation or willful misrepresentation. In this regard, the debtor must prove and the bank must prove its case by clear and convincing evidence as to this element.

The Court finds that the bank

has made a clear and convincing showing in this regard. The case law indicates that a reckless disregard of the truth is sufficient to carry the bank's burden in this regard; and as long as the evidence is clear and convincing. In Re Phillips, 804 F.2d 930, 6th circuit 1986; In Re Kinsey, K-I-N-Z-E-Y, 761 F.2d 421, 7th Circuit 1985, the case cited, incidentally, in the Mullet case; and In Re Black, 787 F.2d 503, 10th Circuit 1986.

The debtor was the chief financial fund raising officer of the debtor. He had a tremendous personal stake in the stock certificates issued to him; and being aware as to the nature of

these stock certificates and how they impacted upon his future financial well-being.

The debtor was engaged in the obtaining of financing on behalf of the corporation from private investors, to whom he had to indicate the shares they were obtaining would be restricted. Obviously, as a prior sophisticated insurance salesman, and as the principal fund raiser of his company, he had to have some working knowledge of what the term restricted shares meant. It belies credibility to think

Transcript Page 121

that the debtor was under the impression that the restrictions

upon these shares had long lapsed. At the very least, the debtor should have entertained some uncertainty concerning whether these shares were, in fact, restricted shares or not.

He had the obligation to ascertain the true nature of the stock certificate before he turned them over to the bank. To proceed otherwise was reckless disregard of the truth, and satisfies the requirement imposed upon the bank of showing by clear and convincing evidence a reckless disregard of the truth from which an intent to deceive may be found.

Once it is concluded that the debtor knew of the restricted nature

of the stock, it follows automatically that he possessed the necessary intent to deceive. If the stocks were restricted, they couldn't be pledged, and the debtor necessarily would be aware that he was misleading the company with respect -- the bank, with respect to a material matter effecting whether the loan would be issued when he turned over the stock certificates and thereby represented that they could be pledged.

The debtor undoubtedly engaged and acted in a good faith belief that eventually his company would pull itself out of its current financial difficulties and that the stock restrictions, if any, would

eventually cease to

Transcript Page 122

exist upon the stock, and that the bank would not be harmed thereby; but the fact is that the bank wa relying upon the certificates as freely transferable and when in fact they were not. They were not properly subject to being pledged for the purpose for which they were tendered; and that is the 75,000 shares of stock.

The bank must secondly show that the creditor relied on the representation. This element has been proven, because the bank would not have made the loan had it been told that the shares were restricted.

The next element that bank must show is that the creditor's reliance was reasonable. Under the Bankruptcy Act, as opposed to the Bankruptcy Code, in interpreting the predecessor to Section 523A-2(a) of the Bankruptcy Code, the Courts were confronted with the situation that frequently occurred where the lenders obtaining from debtors representations in writing or otherwise, that the lenders obviously knew were untrue or which they obviously knew there was a substantial risk were untrue.

They would obtain these representations in order to go into a bankruptcy situation and argue that they had relied upon

representations of the debtor that were false, and therefore that the debt should not be discharged.

To counter this type of unscrupulous practice on the part of the lenders, the Courts developed the doctrine

Transcript Page 123

that the reliance by the creditor must be reasonable n order to prove that the reliance was actual reliance. When the lender engaged in only a facade of reliance, it wasn't actual reliance, and the Courts, in order to get to that unscrupulous activity imposed a requirement of reasonableness on the lender.

The Courts have continued to

apply that requirement of reasonableness under the Bankruptcy Code itself.

Some Courts have taken varying positions on this issue, and those positions are described in the case of In Re Phillips, 804 F.2d930, 6th Circuit 1986, at page 932 -- pages 932 to page 933. To Paraphrase that language, some Courts even do not require any reasonable reliance, because Section 523A-2(a) makes no mention of it in contrast to Section 523A-2(b).

Other Courts have required rigorous proof of reasonable reliance. Finally, a third category of cases, where it recognizes reasonable reliance, but asserts

that, quoting again from a favored opinion, "reasonableness is circumstantial evidence of actual reliance; that is, dischargeability shall not be denied where a creditor's claimed reliance would be so unreasonable as not to be actual reliance at all," end of the quote within the quote, citing In Garman, 643 F.2d 1252, 7th Circuit 1980.

Transcript Page 124

The Sixth Circuit, in that opinion, went on to agree with the Garmand reasoning. This Court is of the same view.

The bank here did not engage in the type of bad faith practice that creditors, many creditors in the past have engaged in when the

Court's developed the doctrine of reasonable reliance.

The bank had no knowledge that the shares here were restricted shares. The bank assured itself that the shares were issued by the company and bore the company's seal. An in no circumstances, cannot be said to have not reasonably relied upon any representations, implicit representations of the debtor that the shares were pledgeable shares.

The final element that the bank must prove is that the creditor sustained a loss as a result of the debtor's representation. When the bank attempted to call upon the collateral, it was unable to sell the collateral, at least what has

been marked as Exhibit number 6 for the Plaintiff, the 75,000 shares of stock.

The remaining shares pledged of 775 shares ere publicly traded stock and could have been realized upon by the bank. To that extent, the bank has not suffered any loss.

The issue wa not argued in closing argument,

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but the record suggests and the Court would fin, in the absence of any other evidence, that the shares after the loan of $50,000 became due in October of 1987, that the shares continued to decline n value.

The Court is attempting to recall the testimony and may have to

take recess in order to do that as to precisely the value of the stock was as of October of 1987, unless counsel can stipulate to that issue, as to what in the record establishes that fact.

MR. KEARNEY: I don't know, Your Honor.

THE COURT: I will take a short recess.

(Brief recess.)

THE COURT: Let me ask you, Mr. Cramer. Is all of page 23 in the record, of the deposition of the debtor?

MR. CRAMER: Yes.

THE COURT: All right. I am prepared to conclude my finding of fact and conclusions of law.

The debtor himself testified that upon deposition, page 23 of his deposition, which is in evidence, that the shares of stock, beginning in the fall of 1987, had declined in value -- had, by the fall of 1987, declined in value.

He stated in reply to the following question: "did there come a time when Applied Optics stock was not trading as favorably as $1.75 a share?" Answer: "Sure,

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towards the end of 1987. The beginning of this year it was trading very low, as much as 25 cents a share."

The record thus contains evidence, from which it may be

fairly found that the shares retained at least 25 cents in value, per share, as of October of 1987, when the loan from the bank became due and payable, the $50,000 loan.

At 25 cents a share, the 75,000 shares that were pledged, were restricted, would have been worth $18,750, had they not been subject to restriction.

The 775 shares pledged that were publicly traded shares, subject to no restrictions, could have been cased at 25 cents a share for the total amount of $193.75.

Thus the loss to the bank of $18,750 could have been mitigated by sale of the -- at the same time, of the 775 shares at $193.75 for a net

loss of $18,556.25, together with -- excuse me.

The Court therefore concludes that the bank has established a non-dischargeable debt of $18,556.25 plus attorneys fees of 15 percent, and will enter judgment accordingly.

Before concluding, I think it is important to remark upon the testimony concerning the debtor's conversations with Thomas Prousalis concerning using the stock as cash collateral to put money into the company to buy stock over the counter, and the fact that the debtor acted with the knowledge of his corporation's attorney.

There is no evidence in the record that the debtor inquired of

the attorney whether the shares were restricted at that time. This is an obvious inquiry that in the circumstances the Court has previously enumerated. The debtor should have made an inquiry into.

The conversation with the attorney does not change the fact that the debtor n the circumstances of this case acted with reckless disregard of the truth, and that the debt accordingly ought to be held non-dischargeable.

For all of the foregoing reasons, judgment will be entered in favor of the bank, declaring that it holds a non-dischargeable debt pursuant to Section 523A-2(a) of the Bankruptcy Code in the amount of

$18,556.25 plus attorneys fees of 15 percent thereon. Thank you counsel.

(Recess.)

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Q Did the bank try to sell either set of shares?

A No.

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF COLUMBIA

In re

RICHARD P. HECKER Case No. 88-00274

(Chapter 7)

AND ELLEN FORBES HECKER,

Debtors

FIRST INTERSTATE BANK OF WASHINGTON, D.C., N.A., SUCCESSOR-IN-INTEREST TO NATIONAL ENTERPRISE BANK OF WASHINGTON, D.C.,

Plaintiff,

v.

RICHARD P. HECKER,

Defendant.

DECISION GRANTING MOTION TO AMEND JUDGMENT

On November 22,1988, trial was held on the Complaint filed by First Interstate Bank of Washington ("the Bank"), plaintiff herein, against Richard Hecker ("the Debtor"), defendant, seeking to have the debts owed to the Bank by the Debtor declared non-dischargeable pursuant to 11 U.S.C. 523(a) (2) (A) and to recover judgment for the amount of the debt, including attorneys' fees. Based upon the evidence before it, pursuant to the findings of fact and conclusions of law read into the record at the conclusion of the trial, the Court held that the loan debt evidenced by a $50,000 note dated October 3, 1986, had been granted by the Bank in reasonable

reliance upon the Debtor's false representation -- made with reckless disregard of the truth -- that the 75,000 shares of

Transcript Page 2

common stock of Applied Optics, Inc. ("the corporation") which he pledged were not "restricted" and were traded on the over-the-counter market. (1) The shares failed to bear a legend noting their restricted character as required by the Shareholders' Agreement executed by the Debtor and others as part of a registration pursuant to the Securities Act of 1933 (15 U.S.C. 77a, et seq.) to make a public offering of other shares of the corporation's common stock. The

Court inferred from the Debtor's reckless disregard of the truth that he had made the false representation with an intent to deceive. As a consequence of the deceit, the 75,000 shares could not be sold on the over-the-counter market (2) and the full principal amount

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Transcript Page 3

of the loan plus part of the additions thereon remain unpaid.

In its earlier decision the Court reasoned that the loss attributable to the Debtor's misrepresentation was the amount that would have been realized upon liquidation of the 75,000 shares had

they been fully transferrable as represented by the debtor. In so doing, the Court relied on decisions, such as In re Mullet, 817 F.2d 677, 680 (10th Cir. 1987) and In re Hunter, 780 F.2d 1577, 1579 (11th Cir. 1986), that require that the lender show that it suffered a loss as a result of the false representation. The Bank has moved for amendment of the judgement with respect to the determination of the amount of the debt held non-dischargeable.(3)

Although the case law is in disagreement, compare In re Brewood, 15 B.R. 211, 16 (Bankr. Kan. 1981) (debt held non-dischargeable only to the extent of the value of the

collateral) with Birmingham Trust Nat'l. Bank v. Case, 755 F.2d 1474,1477 (entire debt held non-dischargeable), the Court is convinced that it erred in limiting the Bank's recovery to the amount by which it would have been secured had the stock been freely transferrable. The better view is that the entire debt is non-dischargeable in these circumstances,

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(3)The Bank's motion, styled amotion for relief from judgment, invokes F.R. Civ. P. 60(b). But the motion was filed and served five days after entry of the Court's judgment and must, therefore, be treated as one under F.R. Civ. P.

59(e) to alter or amend the judgment. Moy v. Howard University, 843 F.2d 1504 (D.C. Cir. 1988).

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for the reasons set forth n Birmingham Trust Id at 1477. First, "the plain language of the statute [which simply provides that the debt will not be discharged] suggests that dischargeability is an 'all or nothing' proposition." Id. Second, like the Court in Birmingham Trust, this Court is not persuaded that the secured creditor suffered damage only to the extent of the value of the collateral. The Court is convinced that the Bank would not have made the loan absent the Debtor's misrepresentations. Thus,

this is not a case where the Birmingham rationale ought not apply because the loan was only partially obtained by the false representation. See Muleshoe State Bank v. Black, 77 .R. 91 (Bankr. N.D. Tex. 1987).(4)

The requirement in Mullett and Hunter that a lender prove the loss that resulted from the deception can be traced

Transcript Page 4

to cases, such as Sweet v. Ritter Finance Co., 263 F. Supp. at 49 B.R. 431, 540, 543 (W.D. Va. 1967), that in turn rely on state court cases reciting the common law elements of actionable fraud. See, e.g., Friendly Finance Co. v. Stover, 109

Ga. App. 21, 134 S.E.2d 837 (Ga. App. 1964). In the case of a loan that, as here, would not have been made at all but for the mischaracterization of the collateral which was pledged to secure the entire debt, the loss arising from the misrepresentation is determined once the debt is established. In the context of 11 U.S.C. 523(a)(2), the common law fraud requirement of showing a loss is already incorporated in the statute's own language requiring that the debt be "for money, property, services, or refinancing of credit, . . . obtain by" the debtor's wrongdoing. A debtor whose misrepresentations induced the

lender to make the entire loan in the first place is not entitled to the benefit of the scenario that would have unfolded had the debtor been truthful. The statute does not limit the lender's recovery to that part of the debt which could have bee recovered after default (based upon the collateral's unexpected decline in value after the loan was made) had the debtor's representations been true.

The Bank is owed $50,000 and, pursuant to the terms of the note, interest or date of $6,314.00 and "all expenses and attorneys' fees incurred in collecting the

Transcript Page 5

Note."(5) Interest is clearly part

of the debt for money obtained by the Debtor's false representation. In re Romero, 535 f.2d 618, 623 (10th cir. 1976); Matter of Church, 69 B.R. 425, 435 (Bankr. N.D. Tex. 1987). The Debtor has not challenged the Court's prior conclusion that the Bank is entitled to attorneys' fees as part of the non-dischargeable debt and that ruling will stand. Courts of Appeal that had addressed the issue, in the context of 523(a)(2)(A) as well as other non-dischargeability provisions, held that compensatory interest and attorneys' fees, if recoverable under state law, are recoverable as ancillary to the debt. While the question is not

free from doubt, the Court is of the view that the technical amendment to 523(a)(2)(A) in 1984 (see footnote 4, supra) is too thin a reed to divorce either interest or agreed attorneys' fees from the debt for money ad that congress did not intend to abrogate the rulings of the Courts of Appeal. See Matter of suter, 59 B.R. 944, 946-947 (Bankr. N.D. Ill, 1986) (citing Courts of Appeal cases). See also Klingman v. Levinson, 831 F.2d 1292, 1296-97 (7th Cir. 1987) (attorneys' fees awarded in State court judgment held to be part of non-dischargeable debt under 11 U.S.C. 523(a)(4)); Kwiat v. Doucette, 81 B.R. 184

191 n. 16 (D. Mass. 1987); Matter of Church, 69 B.R. at 435. Contra, e.g., Matter of Smith, 72 B.R. 300 (Bankr. M.D. Fla. 1987); In re Beard, 5 B.C.D. 680 (Bankr. M.D. Tenn. 1979). Nor did the Debtor challenge the Bank's evidence that an attorney's fee of 15% represents a reasonable fee for collection of this type of debt. Accordingly, the Court will enter an amended judgment awarding the Bank $64,761.10 as a non-dischargeable obligation consisting of $50,000 in principal, $6,314.00 in interest, and attorneys' fees of $8,447.10(6)

Dated: January 6, 1989

S. MARTIN TEEL, JR.

United States Bankruptcy Judge

(1) The Court held as to a later loan of June 3, 1987, that the Bank failed to carry its burden of proving by clear and convincing evidence that the Debtor obtained the loan based upon false pretenses or false representation. This debt was unsecured, the shares of stock were not relied upon as collateral and hence there was no showing that 523(a)(2)(A) applied to this loan. In re Brewood, 15 B.R. 211, 216 (Bankr. D. Kan. 1981).

(2)the Bank's unchallenged evidence was that, upon the Bank's

inquiry into the possibility of selling the 75,000 shares, it was determined that the shares could not be sold. In addition, the parties' pretrial submissions reflect their apparent assumption that the shares could, in fact, not be sold. The unsalability of the shares in the over-the-counter market alone establishes damage from the deceit and the issue of when, if ever, the restricted shares could eventually be sold for any amount of practical consequence is not an issue before the Court. See SEC v. Guild Films Co., Inc., 279 F.2d 485 (2d Cir.) cert. denied, 364 U.S. 819 (1960); L. Loss, fundamentals of Securities Regulation 249, 259-265 (2d ed.

1988); D. Lehr, some Securities Law Issues In Lending on Pledged Stock, 38 Bus. Lawyr. 91, 101-121 (1982); 3 H. Bloomenthal, Securities and Federal Corporate Law 4.09[4] and 4.12[9][f] (1988 rev.); SEC Rule 144, 17 C.F.R. 230.144.

(3)The Bank's motion, styled a motion for relief from judgment, invokes F.R. Civ. P. 60(b). But the motion was filed and served five days after entry of the Court's judgment and must, therefore, be treated as one under F.R. Civ. P. 59(e) to alter or amend the judgment. Moy v. Howard University, 843 F.2d 1504 (D.C. Cir. 1988).

(4) The Bankruptcy Amendments

and Federal Judgeship Act of 1984, Pb. L. No. 98-353, 98 Stat. 333, amended 11 U.S.C. 523(a)(2)(A) to provide for non-dischargeability of a debt "for money. . .to the extent obtained by" false representation. Previously the statute, as construed in Birmingham, had provided for non-dischargeability of a debt "for obtaining money. . .by" false representation. Despite questioning of the validity of Birmingham after the 1984 amendments, in Muleshoe State Bank and in Matter of Church, 69 B.R. 425, 435 (Bankr. N.D.Tex. 1987), the 1984 amendments do not alter the result here because the entire loan was obtained by the false representations. In this

case, the collateral was worth far in excess of the loan when the loan was made and the decline in value was not anticipated. In contrast, in Muleshoe State Bank, the Debtor misrepresented that he owned eight cow and calf pairs which the bank anticipated would realize it an additional $4,248.00 in collections on a $42,000 loan. The bank extended the entire $42,000.00 loan for another 30 days. The loss thus arising from reliance on the misrepresentation was only $4,248.00, not the entire $42,000.00

(5) Although the note provided for late charges of 5%, the testimony regarding amounts due

concerned only principal, interest and attorneys' fees. The Court thus assumes that the Bank has waived any claim to late charges or that payments already received were applied, pursuant to the terms of the note, first to the late charges to eliminate them. Thus, the Court need not decide whether late charges are part of the debt for money obtained by false representation within the meaning of 11 U.S.C. 523(a)(2)(A).

(6) In conjunction with the prior ruling that the Bank's loss was limited to what it could have realized had the 75,000 shares not been restricted, the Court further reduced the Bank's recovery by the

additional amount that could have been realized by the Bank when the debt came due had it also sold 7,500 additional shares of stock of the corporation that the Debtor had pledged after the making of the loan and that were not restricted. The issue might arguably be viewed as subsumed in the issue of how much loss the Bank suffered based on the reliance on the Debtor's misrepresentations. The Court is now of the view that these additional unrestricted shares, particularly since they were pledged after the making of the loan, have no impact on the correct measure of damages under 11 U.S.C. 523(a)(2)(A). If the Bank now sells

these unrestricted shares, the proceeds will be a credit against the Debtor's judgment liability. IF the Bank acted unreasonably in failing to sell these shares earlier, the Debtor may have a claim against the Bank, a matter on which this Court expresses no opinion. Such a claim, however, was not raised here and is not foreclosed by the judgment in this proceeding. If such a claim has any validity, it ought not be decided on this record when neither party directed attention to presenting evidence precisely fixing the value of the corporation's publicly traded stock after the debt came due.

United States Bankruptcy Court

For The District of Columbia

Richard P. Hecker, Debtor

v.

First Interstate Bank of Washington,D.C., N.A., Successor-In-Interest to National Enterprise Bank of Washington, D.C., Plaintiff

Case No. 88-00274

(Chapter 7)

Adversary Proceeding

No. 88-0021

JUDGMENT

This adversary proceeding was tried before the undersigned and a decision having been duly rendered and a motion to amend the Court's prior judgment having been granted, it is

ORDERED AND ADJUDGED that, pursuant to 11 U.S.C. Section 523(a)(2)(A), $64,761.10 of the debt owed by the defendant, Richard P. Hecker, to the plaintiff, First Interstate Bank of Washington, and only that amount, is a debt that shall not be discharges by any discharge in the defendant's pending Chapter 7 bankruptcy case. It is further

ORDERED AND ADJUDGED that the plaintiff, First Interstate Bank of Washington, recover of the defendant, Richard P. Hecker, the sum of $64,761.10, with interest thereon after entry of this judgment as provided by law, and the costs of this adversary proceeding. It is

further

ORDERED AND ADJUDGED that the prior Judgement entered on November 23, 1988 is VACATED.

Dated: January 6, 1989.

S. Martin Teel, Jr.

United States Bankruptcy Judge

United States District Court

For The District of Columbia

Richard P. Hecker,

Appellant,

v.

First Interstate Bank of

Washington, D.C., N.A.,

Successor-In-Interest to

National Enterprise Bank

of Washington, D.C.,

Appellee.

Civil Action No. 89-0323

MEMORANDUM

This is an appeal from a decision of the Bankruptcy Court holding that a $50,000 loan to appellant was not dischargeable in bankruptcy under 11 U.S.C. §523(a)(2)(A) because it was

procured by fraud. Because the Court concludes that none of the findings of the Bankruptcy Court was clearly erroneous, the decision of that court is affirmed.

Background

Applied Optics, Inc., a contact lens manufacturer, was incorporated in 1983. Appellant joined the company in 1985. He was made executive vice president, secretary, and treasurer. Among his responsibilities were the supervision of payroll, purchasing and personnel. As an inducement to join the corporation, appellant was given 17,500,000 shares f stock.

On July 24, 1985, appellant signed a shareholders' agreement.

This agreement provided that no shareholder who executed the agreement could sell, pledge, or transfer any of their stock for 36 months after the effective date of the S-18 registration statement filed with the SEC in connection with the public offering of the company's stock. This S-18 statement was filed on August 22, 1985 and was signed by five shareholders, including appellant, who signed as secretary of the corporation.

Appellant filed a financial statement with appellee's predecessor bank on March 3, 1986 regarding his Applied stock. The statement listed the stock as "restricted." Subsequently,

appellant's shares were converted into 75,000 shares of corporation stock and 100,000 warrants in a 1 for 100 reverse stock split and the bank was so notified. A certificate for the converted shares was issued and was kept by Applied's attorney.

On September 23, 1986 appellant sought a $50,000 loan from appellee for the benefit of Applied. Applied's attorney turned the stock certificate over to appellant and said that it could be used as collateral for the loan. This certificate was pledged as collateral for the loan. It did not bear any restrictive markings on it. The loan was approved by the bank on October 3, 1986. Appellant later

filed a financial statement with the bank, on October 27, 1986, which listed the 75,000 shares of stock, but did not identify them as restricted.

After the company was in bankruptcy and appellant was unable to make payments on the loan, the bank discovered that the stock it held as collateral was not transferable. It sought an order from the bankruptcy court to the effect that the debt was not dischargeable because it was procured by fraud. The bankruptcy court so held and ordered appellant to pay appellee $64,761.10 for principal, interest, and attorney's fees. It is from this order that

appellant appeals.

Applicable Standards

The bankruptcy court properly determined that in order to find that the debt was not dischargeable, it had to find that

> the debtor made a false representation and willful misrepresentation; was made with the intent to deceive; the creditor relied on the representation; the creditor's reliance was reasonable; and the creditor sustained a loss as a result of the debtor's representation."

Tr. at 119, citing In Re Mullet, 817 F.2d 677, 689 (10th Cir. 1987). Appellant does not dispute this standard but only the bankruptcy

judge's conclusion that each of the elements was satisfied in this case.

Similarly, the parties do not disagree as to the standard of review in this Court. According to Bankruptcy Rule 8013

> Finding of fact whether based on oral or documentary evidence shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witness.

Thus, the clearly erroneous standard is the standard of review here.

III

Bankruptcy Court Findings

Recognizing the opportunity of the bankruptcy court to observe

witnesses and evaluate their credibility, this Court does not find that any of the bankruptcy judge's findings is clearly erroneous. It will consider each of these findings to which appellant has objected seriatim.

First. The bankruptcy court concluded that the failure to inform the bank that the stock was restricted was a fraudulent representation because it was made with "reckless indifference to actual facts without examining the available source of knowledge which lay at hand and with no reasonable ground to believe that it was in fact correct." Morimura v. Taback, 279 U.S. 24, 33 (1929).

Appellant asserts that this finding was clearly erroneous since, prior to pledging the stock as collateral, he had been informed by Applied's counsel that he could do so. According to appellant, this is a utilization of an available source of knowledge which precludes a finding of fraud under Morimura. Appellant cites several cases in which conduct in reliance on professional advice is not deemed fraudulent. In Re Jackson, 89 B.R, 308 (1988); Kentile Floors, Inc. v. Winham, 440 F2d. 1128 (9th Cir. 1971). None of these cases, however, stands for the proposition that reliance on professional advice is an absolute defense to fraud.

In this case, appellant had many other available sources of Knowledge. He was the secretary, treasurer, and executive vice president of Applied; and he had signed the shareholders agreement that provided that the shares were restricted, and he admitted that he did know at one time that the shares were restricted. Based on these facts, the bankruptcy court found that the appellant was reckless in relying without question on the statement made by the company's attorney. This finding is not clearly erroneous.

Second. based on its finding that the appellant acted with reckless disregard for the truth,

the bankruptcy court inferred that he possessed the necessary intent to deceive. Tr. P. 121. Appellant also challenges this conclusion. The law is clear, however, that intent to deceive may be inferred based on a finding of reckless disregard for the truth. In Re Garman, 643 F2 1252m 1260 (7th Cir. 1980). As the Court noted in Carini v. Matera, 592 F.2d 378 (7th Cir. 1979)

Where, as here, a person knowingly or recklessly makes a false representation which the person knows or should know, will induce another to make a loan, intent to deceive may logically be inferred.

Based on the facts cited above, this Court holds that, under the totality of the circumstances, the bankruptcy court was not clearly in error in inferring the requisite intent to deceive.

Third. Appellant disputed the bankruptcy court's finding that appellee reasonably relied on appellant's representations. He asserts that the bank failed to use ordinary care by not conducting any investigation into appellant's representations. Resolution of this question depends on the definition of reasonable reliance. In his decision the bankruptcy judge relied on the definition provided by the Courts of Appeals for the Sixth and

Seventh Circuits:

> r e a s o n a b l e n e s s i s circumstantial evidence of actual reliance; that is, dischargeability shall not be denied where a creditor's claimed reliance would be so unreasonable as not to be actual reliance at all."

In Re Phillips, 804 F.2d 930 (6th Cir. 1986), citing In Re Garman, 643 F2d 1253 (7th Cir. 1980).

Appellant contends that the bankruptcy judge misapplied this standard--that reliance on the appellant's false representations without perceiving that they were false based on the old financial statement that was contained in the appellant's files was so

unreasonable as to not be actual reliance at all. The question of whether reliance was reasonable depends on consideration of a great many factors such as the relationship between parties, the number of false representations made, the other information in the hands of the creditor, the nature of the representations. - See, e.g., Carcini, 592 F.2d at 381. As the finder of fact, who heard and observed all of the witnesses, including the bank's lending officer and the appellant himself, the bankruptcy judge was plainly in the best position to evaluate these factors.

In this case, the judge noted

that the bank demanded and obtained a stock certificate, the certificate bore no restrictive marking, appellant never told the bank the stock was restricted, the bank made sure that the shares were issued by the company. t checked their value, and it made sure that they bore the company's seal. Tr. p. 112, 113, 115, 124. Moreover, the bank had done business with the appellant for several years. Based on the testimony to this effect, the bankruptcy court determined that the bank had not engaged in the type of bad faith conduct that the reasonable reliance doctrine was designed to punish. Despite all the appellants arguments as to what the

bank could and should have done, particularly in regard to the notation on the financial statement, the conclusion is inescapable that the bankruptcy court's finding that the bank did not act unreasonably was not clearly erroneous.

Cases in which courts have found that reliance was unreasonable have generally been those in which the lender has actual knowledge of the borrower's poor economic condition which contradicted the evidence upon which it allegedly relied, or those in which funds were extended on the basis of no financial information and no prior relationship to the bankrupt. See, e.g., Kentile Floors v. Winham, 440

F.2d (9th Cir. 1971; Sweet v. Ritter Finance Company, 263 F. Supp. 540 (W.D. Va 1967); In Re Smith, 424 F. Supp. 858 (M.D. La 1976). In view of the positive relationship between Applied and the bank and of the actual, unrestricted stock certificate bearing the corporate seal which the bank obtained before making the loan, the Court cannot find that the decision of the bankruptcy judge was clearly erroneous.

Fourth. Appellant contends that the bankruptcy court erred in concluding cause of the bank's loss. He contends that the bank failed to prove that it could not sell the stock. This is a frivolous

argument. Two bank officers testified that they looked into selling the stock and concluded that it could not be sold. It is clear from the testimony in the case and from the shareholders agreement that, when the loan default occurred, the stock was still subject to SEC restrictions on the sale or transfer of the stock. The bank could not sell the stock because it was not the bank's to sell.

Fifth. Appellant maintains that he should have been given credit for the $18,500 that he contends the bank could have obtained by selling the stock, for $193.25 that it could have obtained

by selling the additional 7,500 shares of publicly traded stock that the appellant also pledged. For the reasons stated above, this Court concluded that the bankruptcy court's refusal to credit appellant for the sale of the 75,000 shares was not clearly erroneous. Moreover, the bankruptcy court stated that in the event he bank sells the additional 7,500 shares, appellant will be entitled to a credit for the amount recovered. Decision Granting Motion to Amend Judgment at 7 n. 6.

IV

Conclusion

For the reasons detailed above, it is the conclusion of this Court

that the decision of the bankruptcy court was not clearly erroneous, and that the decision is therefore affirmed.

Harold H. Greene

United States District Judge

September 22, 1989.

Shareholders' Agreement
(pp. 105-106 only)

3. Legend and Fututre Issuances:

The terms of this Agreement shall be applicable to, and the following legend shall be noted conspicuously on, all certificates representing Common Stock heretofore or hereafter issues to the Shareholders:

THE SECURITIES REPRESENTED BY THIS COMMON STOCK CERTIFICATE HAVE BEEN AQUIRED PURSUANT TO CERTAIN INVESTMENT REPRESENTATIONS ON THE PART OF THE PURCHASER HEREOF AND SHALL NOT BE SOLD, PLEDGED, HYPOTHECATED, DONATED OR OTHERWISE TRANSFERRED, WHETHER OR NOT FOR CONSIDERATION, BY THE PURCHASER EXCEPT UPON ISSUANCE TO THE COMPANY

OF A FAVORABLE OPINION OF ITS LEGAL COUNSEL AND/OR SUBMISSION TO THE COMPANY OF SUCH OTHER EVIDENCE AS MAY BE SATISFACTORY TO LEGAL COUNSEL TO THE COMPANY, IN EITHER CASE TO THE EFFECT THAT ANY SUCH TRANSFER SHALL NOT BE IN VIOLATION OF THE SECURITIES ACT OF 1933, AS AMENDED, AND APPLICABLE STATE SECURITIES LAWS.....